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¶1. (SBU) Summary: In a series of consultations with fund managers, securities firms and investor advisory firms from March 4-14, TDY Econ Officer solicited views on the drivers of China's equity markets. An overarching theme is that China's stock markets should be viewed in the special context that the government is both the majority shareholder and the market regulator. This fact, combined with China's relatively insulating capital control framework, means that market swings in China may in some cases demonstrate a certain degree of autonomy from global trends. Interlocutors noted that as Chinese markets mature, economic trends and macroeconomic policy moves are having a greater impact on price trends. Given the overall lack of transparency in economic policy making and the often poor quality of economic data in China, stock market trends may increasingly provide useful forward-looking signals on the direction of China's economy. End Summary.

China's Equity Markets are a Work-in-Progress

¶2. (SBU) As domestic stock investors, brokers, and advisors from both Chinese and joint-venture firms noted during meetings with TDY Econ Officer from March 4-14, despite high market capitalization and robust share-offering activity, China's emerging equity markets are still mid-stride in a decades-long reform process. The Shanghai and Shenzhen stock markets are fundamentally different than most international markets and thus China-specific factors must be taken into account when tracking Chinese market movements against global trends. The government has strong control over share supply as well as influence over share demand. As both the largest shareholder and the market regulator, the Chinese Government oversees a "policy market" marked by high volatility. Overall, the absence of tools to take short positions in the market means that profits come only

from market gains.

Non-Tradable Share Reform and the Supply of Shares

¶3. (SBU) Central to China's equity market development is the non-tradable share reform, which phases in the proportion of a listed company's equity that is permitted to be traded. The plan for share reform was introduced in 2005, allowing for increased tradability over a multi-year timeframe. Clarification on how the "share overhang" would be allowed to flow into the market helped to reassure investors and foster the 2006-2007 boom. (Note: The Shanghai Stock Exchange Composite Index rose 130 percent in 2006 and 97 percent in 2007.) Similarly, shares issued in initial public offerings (IPOs) are bound by non-tradable lock-up periods. Aggregating data on a firm-by-firm basis, one research team estimates that from 2007 to 2010, the overall "free float ratio" will climb from near 10 percent to 90 percent of total shares, with trillions of shares becoming tradable in that time frame. Uncertainty about the proportion of those shares that will actually be unloaded on the market creates volatility and supports herd behavior in the market, which is exacerbated by information asymmetry.

¶4. (SBU) Even as the non-tradable share reform phases in, authorities retain considerable control over the supply of new shares entering the market. Authorities can control the availability of shares to guide investor expectations. Though few interlocutors think the government will suspend the non-tradable share reform in the event of a soft market, they believe the authorities may lean on large firms to withhold sales of newly tradable shares. In the event of excessively high valuations, authorities might encourage share selling by firms with newly tradable shares. Further, approval for all

IPOs and secondary share issuances is granted by the China Securities Regulatory Commission (CSRC), providing another check on share supply. The CSRC modulates the pace of approval for share offerings depending on market conditions.

¶5. (SBU) In the course of discussions, interlocutors noted that Chinese authorities take measures to influence share demand as well as share supply. To stoke share buying, the CSRC approves quotas for new asset management funds. Expanding access to the domestic market for foreign investors by raising quotas for Qualified Foreign Institutional Investors (QFIIs) is another option for policymakers to increase share demand. In addition, authorities may increase the proportion of assets that pension funds and insurance companies can invest in equities. Several interlocutors noted that the CSRC has in the past resorted to use moral suasion to encourage asset management funds to buy shares, either during meetings with fund managers or through phones calls. One director at a joint venture securities firm saw this approach as decreasingly effective, as fund managers are more concerned about their professional reputations and performance than doing favors for the CSRC. In his observation, efforts in the past two years by the CSRC to encourage buying by funds had no discernable impact on the market. He noted that even if the CSRC pressed large, cash-flush state-owned enterprises (SOEs) to buy shares, SOEs are now bound by performance targets and increased managerial accountability, which would limit their cooperation. The director commented that if a fund manager or SOE were to ultimately lose money from such share purchasing, the CSRC would not bail them out.

Structural Changes and Market Reform

¶6. (SBU) In several conversations, interlocutors noted that fast-moving economic development and reform measures impact the composition of investors, company valuations, and investor expectations. Investor composition has fluctuated in recent years. The plan for non-tradable share reform boosted investor

confidence and drew droves of retail investors to a booming market. However, market swings since May 2007 have led retail investors to move substantial assets to accounts overseen by professional fund managers.

¶7. (SBU) But fund managers indicate that share valuation is complicated by weak accounting practices, changes in accounting rules in 2006-2007, and the large amount of corporate restructuring and mergers and acquisition activity. An individual firm's price-to-earnings (P/E) ratio may reflect hidden value or may overstate underlying value. For these reasons, the usefulness of index-wide P/E ratios is limited. The fact that investors can only take long positions on shares creates an upward bias to P/E ratios in China.

¶8. (SBU) Both the announcement and implementation of reform measures can have a notable impact on China's stock markets. For example, in May 2007, the Ministry of Finance raised the stamp duty on share trades from 0.1 percent to 0.3 percent, precipitating a large drop in the market. (Note: The Shanghai Composite Index fell 15 percent from May 30 to June 4.) Authorities have delayed the launch of equity index futures for fear of a dramatic impact on the market (cf. reftel). (Note: Interlocutors generally thought that introduction of stock index futures and other means to short the market will be an important step for the maturation of China's stock markets, especially as a means to facilitate price discovery.) In February 2008, authorities mentioned consideration of a pilot stock margin buying framework, an announcement seen by investors as an attempt to boost the market. Investors may also react to the government's periodic measures to liberalize the capital account, given the resulting change in perception of demand for shares.

¶9. (SBU) The reform process in China's stock markets lends to

uncertainties and price volatility. At the same time China's stock prices are increasingly reflecting domestic macroeconomic developments and global events. China's stock markets are becoming more sensitive to economic data releases and statements by senior policy makers on macroeconomic policy measures. While China's controls on portfolio investment flows insulate domestic stock markets, the Qualified Domestic Institutional Investor (QDII) and QFII programs provide a channel for portfolio inflows and outflows, though quotas are carefully governed. Interlocutors noted that movements in China's domestic "A-Share" market are becoming more correlated with the Hong Kong market, which itself tracks trends in the United States. Stronger correlation with overseas markets is especially apparent for firms that are cross-listed in overseas markets.

¶10. (SBU) Interlocutors highlighted a perception among investors, particularly among less-experienced retail investors, that the government would use the measures outlined above to ensure that markets continue to rise. Previous government interventions support this notion, creating expectations for future interventions and moral hazard. During past market downturns, reports circulated of disgruntled investors protesting at government offices and of an investor phoning in a bomb threat to the local Ministry of Finance building. One securities firm director professed that the CSRC's ability to control the market is weakening, and he noted that if stock index futures are launched, the CSRC may lose control completely.
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